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Contra-cyclical Fiscal Policy - Is it Dead?

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July 1998

Foreword

This paper was presented at Dalhousie University in March 1998 as the 1998 John F. Graham Memorial Lecture. This lecture is an annual event which is supported by a memorial fund established in memory of John F. Graham, a long-time member of the Dalhousie Department of Economics, who died unexpectedly in 1990.

John Graham was a member of the Economics Department at Dalhousie from 1949 to 1989, when he retired. He was Department Head from 1960 to 1970. He was a public finance economist who specialized, in particular, in the field of intergovernmental fiscal relations. He was a consultant to the Bryne Royal Commission on Finance and Municipal Taxation in New Brunswick in the early 1960s, the Newfoundland Royal Commission on Education and Youth in the late 1960s and he chaired the Nova Scotia Royal Commission on Education, Public Services and Provincial-Municipal Relations in the 1970s. He was President of the Canadian Economics Association in 1970-71 and Vice-President of the Royal Society of Canada in 1977-78. He was, perhaps above all else, an educator, who was deeply committed to teaching.

The Annual John F. Graham Memorial Lecture is intended to deal with significant issues in public policy in Canada at a level that is directed at students and the general public. It was our honour to have Michael McCracken, chief executive officer of Infometrica Limited in Ottawa, deliver the seventh Annual John F. Graham Memorial Lecture and it is our honour to publish his remarks in the Department of Economics Working Paper Series.

Barry Lesser
Chair

Halifax, January 12, 1999

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Introduction

When asked to give this lecture, the stress was on public finance issues, as appropriate given John Graham's past work and interests. Indeed I jumped at the chance to harden some ideas around a topic that had been a nagging concern for some time.

With the many changes that have been occurring to the tools of the federal government, their responsibilities, and the nature of the economy I have been concerned about the capacities of the Canadian economy to restore itself after an adverse economic shock. Nothing about its behaviour in the recession of the 1980s or 1990s has made me more confident.

But in preparing my thoughts it has become clear that something else has changed. There is less trust in the institutions of government. The social cohesion that helped to build the sharing economy through the 1960s and early 1970s has been seriously weakened.²

The reason that recognition of this underlying change is important is that any "fix" or set of recommendations must deal with the need to ensure that governments will carry out their responsibilities. And, in typical Canadian fashion, it is necessary to address whether these concerns are a federal or provincial matter!

Before turning to the issues around the social compact, let's look at the macroeconomic circumstances that we are now in.

Where We Are

With unemployment still above 8% and the unemployment rate not declining below 7% since the late 1970s, it is clear, at least to some of us, that the Canadian economy is running well below its potential. Indeed, the "gap" between potential and actual is likely to be 10% or more at the present time, if one assumes that full employment would have an unemployment rate of 4% or less. Okun's Law would suggest an output gap of 2.5 times the difference in the current level of unemployment (8.5%) and full employment. Of course, this view is not shared by everyone.

The Bank of Canada and Department of Finance would ask, "What gap?" or would suggest we are about to hit the wall of full utilization of resources, with a view of the appropriate level of

¹This paper is based on the Graham Lecture at the Dalhousie University on March 16, 1998. It has benefited from editorial comments from Professor Barry Lesser of Dalhousie, although the author remains responsible for the views herein.

²This material draws on an article by Robert B. Reich (1998). As well, the book by Francis Fukuyama (1995) influenced some of the ideas.

unemployment at about 8%. Their policies are aimed at preventing such an approach, given their aversion to inflation. Indeed, as part of the 1998 Federal Budget, the Finance - Bank of Canada Compact was renewed, with inflation targeted to remain between 1 and 3% at all costs.

The debate about how much room we have for further growth is an important one. But today I want to talk about what happens if there is another shock to the economy that pushes us into growth rates even farther below the potential growth rate, implying rising unemployment. This makes the issue of the potential level of output moot.

What will happen? If the shock is internal, through a rise in domestic interest rates or further fiscal tightening, then presumably governments are trying to raise unemployment and will do little about reversing their policies. This was essentially the story in 1990-95, with both fiscal and monetary policy tightening the screws on the economy. Indeed, it was part of the story in 1981-82 as well, with higher interest rates and fiscal restraint triggering the recession, aided by higher US interest rates and a weaker US economy.

But what if the shock is external or not a deliberate act of government? This could be triggered by a weak demand for Canadian exports, reflecting a US recession or the fall-out from the Asian difficulties. It could originate with a supply-side shock, such as a jump in OPEC prices or other commodity prices, which again would work through the trade balance, and a weakened US economy, to reduce growth in Canada. Or it could be a change in "animal spirits", with substantial declines in private investment, cutbacks in employment by firms, and an increase in personal savings out of fear, or to pay back insistent bankers.

If there is a recession and if the last two recessions are any guide, government will do little to reverse the fortunes of the country. Indeed, with their "hell or high water" fiscal targeting, they may even move to raise taxes or cut expenditures.

What is "broken"?

Protections that were part of the economy in the past were "automatic stabilizers". These refer to those government programs that had a characteristic of providing some fiscal stimulus in times of recession, without requiring new legislation or even recognition of the problem by governments. These included:

- UI program - with rising unemployment, increased UI benefits help cushion incomes and support consumption;
- Social assistance program - similar to UI but at a lower rate of income support;
- Personal income tax system - reduction in effective tax rate with loss of income.

However, changes in these programs have modified the way in which they work in recessions. Recent changes in UI (to EI) have reduced the number of people covered (to less than 50%), reduced the benefits paid (lowered replacement rate to 50-60%), and shortened the period of benefits (from 50 weeks to 38 weeks). This will reduce the effectiveness of UI in cushioning the economy in a recession.

The changes in the financing of social assistance (SA) now means that the federal government will not put a penny more into SA in the face of a recession. Provincial actions will depend only on their own decisions, but past performance is not suggestive of much support for expanding SA during a recession.

As well, with fewer tax brackets, there is less automatic stabilization built into the personal income tax system. But in some ways the changes are even more profound. The whole notion of stabilization has changed.

How the Notion of Stabilization Changed

- Since the OPEC price shocks of 1974 and 1980, inflation control has become the over-riding concern of governments. This reflects the concern of asset holders, who have much more influence with governments than the unemployed, the poor, or debtors.
- As a result, governments have chosen to operate the economy with substantially more slack (i.e., higher unemployment) than in the 1960s or early 1970s. This is part of the anti-inflation war, as well as a consequence of the decision to protect the rates of return on assets. The post-war dedication to "full employment" which was defined as 3% by the Economic Council of Canada in the mid-60s, has disappeared. In its place is a notion of "average" performance in the recent past - a moving average of increasingly mediocre performances.
- Real interest rates moved to significantly higher levels from the late 1970s on, as a result of concerted action by central banks around the world. This setting remains in place today. Indeed, real interest rates now exceed real economic growth in most countries, implying an on-going transfer to asset-holders of an increasing share of the economic pie. Since these asset-holders have a relatively low propensity to consume, it should not be surprising that we have been operating in an environment of weak effective demand since the late 1970s.
- The impact of the changes in automatic stabilizers has been to reduce their effectiveness. In the last recession, the federal government increased UI contribution rates during the recession, worsening the situation. The major changes are more recent. We have yet to "test" the new EI and the decentralized SA system in a recession.
- The Canadian economy has become more open, with larger import shares and export shares. This trend has been a long-term one, but with substantial increases since 1988, with the implementation of the FTA and then NAFTA.

At present, about 40% of any increase in consumption is imported. Even a larger proportion of machinery and equipment investment leaks out of the country. As a result, almost any stimulative fiscal policy is likely to have a smaller multiplier today, than in the 1980s or the 1970s.

The other major leakage is into government revenues. Any increment in GDP results in a substantial increase in government revenues - about 40%, either into federal, or provincial, or local coffers. The major problem is that if they do not quickly re-spend it or otherwise recycle it, then the multipliers are reduced. Unfortunately, governments usually watch the improvement, attribute it to their superior policies, and do not act to improve the effectiveness of the initial injection of spending power.

As a result of these changes in the characteristics of the economy, it is difficult to find fiscal instruments with substantial multipliers. Indeed, some think that fiscal policy has become totally ineffective for these reasons.³

- One of the characteristics of the Canadian economy is the persistence of rather different levels of performance in different regions, and the likelihood at any point in time that some regions need more help and others less help. The federal government can always beg off its responsibility by pointing to the “too tight” region, like downtown Toronto in the late 1980s, as an excuse for restraint. Of course, a “too tight” Toronto would be just the thing needed to encourage firms to relocate from the centre to lower-cost sites elsewhere in Canada (e.g., the Maritimes).

So What?

With these many changes to the operating environment of governments, and the re-direction of policy away from full employment to “stabilization” that has been re-defined as low inflation, a balanced budget and a viable balance of international payments, where are we left?

There is a sense of betrayal, a lost of direction, a failure of leadership - all of which can be seen as a loss of social cohesion, or in Robert Reich’s [Reich 1998] words - the social compact is coming undone.

A Social Compact

One of the problems in discussing these topics is a lack of standard definitions for many related concepts. This may be more reflective of my problem as an economist than any weakness in sociology. In any case, the terms I am using are defined as follows:

³Monetarists of course, argue that fiscal policy is ineffective for quite different reasons.

Culture - a set of ethical habits and reciprocal moral obligations internalized by each community's members. [Fukuyama, 1995, p. 9]

Trust - dependability that members will follow the norms defined by the culture

Social capital - capital that arises from the prevalence of trust in a society or in certain parts of it. This can range from the family to a nation, and is reflected in the adoption of a set of common [Fukuyama, 1995, p. 26] norms. One effect of social capital is to reduce transaction costs.

Social compact - a similar notion to social capital, but broader in defining the relationships between different groups or communities (business, employees, governments, etc.). It includes:

- the obligations of members in society to each other;
- defines a society or culture;
- a mix of explicit and implicit contracts.

There are several provisions of the social compact and these include:

- *Companies Sharing Benefits with Workers* - "As companies do better, their workers should too." In essence, rising real wages would accommodate increases in productivity; new jobs would follow from corporate success.
- *Stakeholder Involvement and Benefit* - This same private-sector expansion would benefit other stakeholders - the local community, customers, and stockholders.
- *Social Insurance*
 - *UI*: If unemployed, replacement income would be made available to allow for other work to be found. In Canada, there was little difference in treatment whether the loss of a job was the result of a decision by the employer or the employee. In some sense, the result was a "lack of fit", and the agreement was that the person would seek employment elsewhere, supported in that search by UI benefits.
 - *Social Security*: The post-war baby bonus became universal Family and Youth Allowance. Old Age Security payments (OAS) were provided to all people over 64, with additional funds to those in financial need through the Guaranteed Income Supplement (GIS). The Canada Pension Plan (CPP) was instituted in 1967 to provide a minimum base for workers' retirement, and followed by a tax-subsidized registered retirement savings plan to cover those not otherwise covered with private pensions.
 - *Social Assistance*: Provinces undertook to ensure that the poor, unable to find work or to work for health reasons, were provided an adequate income. The cost of this was shared by

the federal program through the Canada Assistance Plan (CAP), with the provision that the program be accessible to all in need without delay.

- *Health Care*: Based on the successes in Saskatchewan, hospital and medical care was provided by the provinces, again with federal cost-sharing and with emphasis on universal access, without direct payments by users. All of these provisions for social insurance reflected a collective will to share the costs of such risks through pooled funds, with the expectation that those who needed it should have it.

- *Access to a Good Education* - Free education through secondary school had become a standard, with substantial growth in post-secondary education (universities, colleges, etc.) also provided in a highly subsidized way. The “deal” was that a student would work hard, give up early entry into the labour force, and, in return, would receive a good education largely paid for by the state. The state would expect to recoup its “investment” many times over through the tax system and the reduced pressure that a more educated person should place on the social safety nets.
- *Regional Redistribution* - In Canada, there was also an element of regional redistribution - partly reflecting the vastness of the country, and partly reflecting the lack of mobility of Quebecois as a result of the lack of French-language services elsewhere in Canada. This notion of regional redistribution is a part of the Canadian social compact, with the emphasis on “place prosperity” as well as “people prosperity”.

The commitment to regional redistribution was made visible through equalization, through regional economic development activities (DREE, DRIE, etc.) and through major capital projects with regional implications.

The Breaking of the Social Compact

Although frayed edges may have appeared in the mid-1970s, the social compact seems to have started coming apart in Canada and the US around the late 1970s and early 1980s and is continuing to do so today. It has, moreover, broken down on all fronts - corporate, labour, governments, and families.

Business

The form of the problem includes: Downsizing, declining real wages, loss of benefits, anti-union activities, loss of pensions, consolidation of plants, off-shore movements of multinationals, etc. Polarization of wages also has occurred, with only the top jobs receiving real growth in value and with declining real wages in most jobs.

Labour

Labour withdrew from any consensus-based institutions with the federal government and began an attempt to regain strength through confrontation and strikes. This in the end accomplished little, although the alternative strategy is not clear.

Governments

Perhaps the biggest disappointment has been the behavior of governments. Rather than trying to maintain the compact and offset the shocks, they have picked up the rhetoric of the private sector and applied it to their own operations. We have seen this in the form of downsizing of public employment, user fees, and pushing off on to others the responsibility for government functions (downloading, or "home care" or soup kitchens). More specific points include:

- *Government cutbacks of all parts of the social insurance package* - In the early 1980s almost all unemployed people received UI benefits. In 1997, this number is less than half, real benefits per week are lower, and the duration of benefits is shorter.

Family Allowances have disappeared to be replaced by a child tax benefit without indexing. Promises of daycare have proven to be empty. Social assistance benefits have been cut absolutely and are not indexed.

Health care is under strain in every jurisdiction, with substantial real declines in per capita spending, adjusted for demographic changes.

- *Rising tuitions at tertiary institutions* - Provincial governments have increased tuitions and other fees for post-secondary institutions, while reducing grants to the same institutions. Real spending per student continues to decline.
- *Abandonment of regional development* - The federal Department of Regional Economic Expansion is no more, and the loan-oriented replacements are small and declining in influence. (ACOA, WEDO, Northern Ontario, and Quebec - FORD). Professor Graham would have found these actions particularly reprehensible. He had pointed out strongly that

"The sensible objective of federal regional development policy is to attain the full and productive use of resources in all provinces in concert with the provinces, having due regard for the provinces' views of their own interests, while at the same time affording all citizens the greater scope of opportunities open to them throughout the whole country." [Graham 1986, p. 23]

- *Downloading on provinces* - Initially the federal government slowed the growth of transfers under Established Programs Financing (EPF). This was evident from 1984 through 1991. Then, in the middle of the recession, they put a maximum growth ceiling of 3% on the Canada Assistance Plan (CAP) for the three relatively well-off provinces (BC, Alberta, and Ontario). But this was not enough. In 1995, the federal government abandoned CAP and EPF unilaterally, and brought in the Canada Health and Social Transfer program (CHST), with dramatically less cash and no link to provincial activities.

These shocks to provincial balances, in turn, led to cutbacks of spending by the provinces, increased taxes, and a reduction in transfers to municipalities. In turn, municipalities have reduced services, increased user fees, and attempted to encourage those in need to move to other areas.

Individuals and families

While all of these shocks are coming from business and governments, people are also changing their behavior. In the US, this change was described by Amitai Etzioni [1996, p. 65 ff.] as follows:

"... from 1960 to 1990 there was a rising sense of entitlement and a growing tendency to shirk social responsibilities. Americans felt that governments should be curtailed and that they should pay less taxes, but at the same time they demanded more government services on numerous fronts.

"The role and influence of religion declined.

"By the 1980s, Americans paid only lip service to some core values and showed significantly lower commitment to others - marriage for instance.

"Respect for authority declined sharply.

"Voter turnout declined.

"Alienation rose."

Does this sound familiar? Let's look at the outcomes in two economic areas - real wages and real disposable incomes.

Real Wages and Productivity

Real wages (including unincorporated income) have been losing ground relative to economy-wide productivity for many years. There was some "catch-up" in the early years of the recession when productivity declined and real wages rose modestly. However, the gap is now over 8% and it is projected to narrow only slowly through 2006. This poor performance of real wages is one of the reasons for the dismal income growth, and also is part of the reason for the increasing disparity of earned incomes between the rich and the working poor.

From the perspective of employers, the wage bill adjusted by their deflator for output, before indirect taxes, shows a different story. The real wage growth has more than kept pace with productivity growth, with a considerable gap in favor of workers opening up during the recession.

The problem is partly the role of indirect taxes. As well, there may be a "disconnect" between the prices seen by business and the prices used in the CPI. A depreciation of the exchange rate is likely to influence consumer prices more than the GDP deflator. This is part of the story since 1992.

Real Incomes

One of the sources of discontent in Canada is the lack of progress in the growth in real disposable income per household. Although there was some recovery in the 1980s after the recession, the more recent recession plunged the consumer back into a funk. Levels declined below those in 1982, and have so far failed to show any sustained progress. Indeed, incomes per household have declined every year since 1989. The prospect, starting in 1998, is for some improvement to set in. It will be 2005, however, before levels are back to 1981 values. (This is based on a "current policies continued" case.) In essence, 25 years will have passed with no real income gains on average.

Why is this Happening?

Robert Reich's [Reich 1998] list includes:

- Things became too good for some - no external threat or shared adversity; loss of sense of mutual dependency;
- International and domestic mobility of the skilled, talented or wealthy leads to less need to ensure a vibrant local economy;
- Disconnect between employees and customers with international trade;
- Risks not commonly shared - large disparities lead to a sense that access to health, education, UI, SA are only for the "poor", not "my" class;
- Detachment between classes - no buying power, no voting, no contact - all make the poor invisible.

I would also point out the role of high real interest rates in excess of the real growth rates of most economies. This was not the condition prior to the late 1970s and early 1980s. Yet this condition remains today in most countries (except Japan).

With high real interest rates there is a substantial transfer of income from debtors to asset holders. As well, government debt ratios become dynamically unstable, requiring any increase in transfers to one group to be immediately financed with a tax increase or transfer reduction for another group. All of this increases polarization in society, while handicapping the economy through slower growth and restrictive fiscal policy.

What It Means

Some of the consequences of these change include:

- The breaking of the social compact which
 - Threatens the social stability and moral authority of the nation;
 - Undermines economic growth, as lower social cohesion dampens productivity;
 - Reduces support for free trade, capital mobility, open immigration, deregulation;

- Threatens the unity of the state.
- "Social capital .. can be dissipated by the actions of governments much more readily than those governments can build it up again." [Fukuyama 1995, p. 362]
- "The social compact is a promise we made to one another, and we are not keeping it when we can most afford to." [Reich 1998]

Restoring Trust - what to do?

Focus on full employment

By restoring the objective or goal of full employment to government, there would be a restoration of an important principle from the 1960s. This would reflect the utterances of governments today - "Good social policy begins with a good job." [Finance 1994, p. v]

Imagine what the situation today would be if we were producing 10% more or about \$80 billion more output per year, with an unemployment rate of 4% or less, and a job available for all who want one. At the same time, government balances would be greatly improved, and other social activities could receive the attention they warrant.

John Graham in 1986 noted "... fighting inflation by restrictive monetary policy is misguided and destructive. ... unemployment should be ruled out as a means of fighting inflation." [Graham, 1986, pp. 21-22]

Indeed without a commitment to this goal, the answer to the question in the title - Is contracyclical policy dead? - must be yes.

Given this commitment, there are many other important elements that also need to be addressed. Reich's list includes:

- Increase progressivity of income tax;
- More resources into schools, daycare, health services;
- Help workers organize;
- Improve training in the workplace; and
- Increase involvement in politics of the weak.

To this I would add in the Canadian context:

- Improve our consensus-building institutions;
- Increase engagement of people; and
- Sort out federal-provincial roles.

Indeed it is to this last, but not least, element that I now turn.

Sorting out federal-provincial conflicts

Achievement of any sort of long-term stability in governing requires that the federal-provincial financing arrangements be reviewed again. In the 1995 Budget, the federal government dashed provincial hopes for a return to some joint basis for funding social programs by announcing a new Canada Health and Social Transfer program(CHST) as a replacement for both EPF and CAP. This involved further major cutbacks in cash transfers to the provinces and the maintenance of the imbalances that resulted from the cap on CAP in the provincial distribution of payments. Indeed, it attempted to put the provinces in conflict with each other by suggesting they come up with a new sharing formula among themselves for the much smaller pie. The provinces refused to take the bait and have left the division to the federal government. Provincial reactions to the reduction in federal transfers included substantial cuts in health and social assistance expenditures, increases in tuition fees, and other forms of restraint.

In the 1996 Budget, and with a close call in Quebec on the referendum, the federal government announced its own rules for the allocation of payments among the provinces, and committed to a minimum cash payment of \$11 billion from fiscal year 1998-99 through 2002-03. This "iron-clad" guarantee is viewed by the federal government as a major positive move. Indeed the budget says that,

"This is the first budget to take action to increase the rate of growth in these transfers since the era of restraint began in the mid-1980s." [Finance 1996, p. 57]

Presumably they are not considering the "actions" taken by previous governments which resulted in a major recession and a substantial increase in CAP payments, at least to some provinces. In turn, the choices of higher unemployment and increased inequality are also choices about health, even though this dimension is not featured in government reports. In a recent UK paper, Richard Wilkinson claims, "... the distribution of income is the single most important determinant of levels of health in the developed world." [Wilkinson 1993, p. 35]

In the 1997 Budget [Finance 1997], there was little to please the provinces. Federal actions in education and health were limited and focused on R&D, student loans, and an increase in the education credit. For low-income families, the federal government announced an increased Child Tax Benefit, with provinces re-directing their savings on social assistance from this program to improve services for low-income families with children. Of course, the provinces may or may not do this, or may announce changes but cut elsewhere.

In the course of the federal election campaign, an announcement was made that CHST would be increased starting in 1998-99 by \$700 million, with subsequent increases to about \$1,400 million. This essentially raises the CHST cash floor to \$12.5 billion, beginning in 1998-99 [Liberal Party, 1997, p. 58]. This change was confirmed in the first federal budget in 1998 [Finance 1998].

At the same time, the federal government promised to increase the Child Tax Benefit by another \$800 million in two stages, requiring the provinces to fiddle more with their social assistance programs. A new Millennium scholarship fund and a number of tax measures around education were announced. The federal government has returned to the social field through the tax and individual grant window, although with little apparent concern about provincial reactions.

Implications for Provinces

Over the next several years provinces must deal with the substantial reductions in cash transfers from the federal government. Permanent drops of about \$3 billion in 1996-97 and another \$3 billion in 1997-98 reduced cash transfers (for health, education, and social assistance) from about \$18.5 billion in 1995-96 to \$12.5 billion in two years. Of course, these transfers are no longer tied to any particular expenditures by the provinces, although they are an important source of their total revenue. In essence, the provinces are now responsible for 100% of any growth in health and education whether attributable to inflation or increased demographic pressures or upgrading of services. For social assistance, even the relatively poorer provinces no longer face a 50-50 sharing regime. All social assistance funding increases (or changes) are the responsibility of the provincial government.

Of course there is one advantage for the province. Any savings that materialize in social assistance, health, or education will accrue entirely to the provincial government. This provides a major incentive to "pare down" the social systems wherever possible.

The major cutbacks of transfers to the provinces will ensure that the provinces remain under the "fiscal gun", with tax increases, expenditure cuts, and "down-loading" onto municipalities and "privatization" of functions to be expected in many areas. And that is the good news!

The bad news is that in the next recession, the fiscal hit will occur on the provinces much more so than on the federal government. The "automatic stabilizers" of the past have been severely weakened, and provinces are much more likely to be forced to cut their expenditures or raise taxes during a recession, steps which will ensure that the recession is deeper and longer than is necessary.

Suggested Principles for Federal-provincial Programs

The CHST is a federal program, without any meaningful provincial input and with the continuing threat of unilateral change by the federal government, without notice. This "right" has been confirmed by the federal courts in the context of the provincial challenge to the "cap" on CAP in 1991. Although there is no immediate indication of any willingness of the federal government to modify this autocratic, paternal stance, what follows are some thoughts about what might be a more desirable system for all parties - federal and provincial governments and the clients of these social programs.

The suggested principles are consistent with a federation and the notion of subsidiarity. The federal government has a better capacity to raise revenue in a less distorting and more efficient way than the provincial governments. As well, it has a leadership role to promote standards and to promote rapid transmission of new ideas and productivity improvements. At the same time, provinces (or their agents - local governments, universities and hospitals) have some advantages in the delivery of services to people.

The question is whether some *national* (federal and provincial) arrangement can evolve which is more stable and satisfactory to all of those involved. It is to that end that the following ten principles are offered for consideration.

1. *Talk cash* - Only the federal government continues to use "tax points" and cash in describing its programs. This makes the numbers look bigger, and is a reminder to the provinces that the federal government "gave" them tax room when it modified the shared-cost programs in the early 1970s. Although the EPF system was a blend of tax points and cash, with a base level indexed to GDP and population growth, the CAP was a shared-cost program of cash transfers only.

If the federal government intends to be directly involved in the health, education, and social assistance areas in the future, it is necessary and desirable for it to make a meaningful commitment in the form of a cash amount each year, according to a defined arrangement.

2. *Long-term commitment* - The agreement between the federal and provincial governments should be on a multi-year basis, of at least five years, with a provision that it continues unless re-negotiated after prior notice of several years by either party.

3. *Minimum level* - The federal government should commit to a minimum cash transfer. If, instead, the federal government wishes to retain the ability to alter the amount at any time, without prior notice, then it would be better if the federal government did not waste people's time with consultation, etc. (The recent exercise was not helpful.)

4. *Reasonable distribution formula* - With the issue of cash distribution, any needs-based formula becomes a variant of equalization with better-off provinces giving up cash for the benefit of other provinces. Alternatively, if an equal per capita cash transfer is used, then the better-off provinces will receive the same amount of cash and the only redistribution program among provinces will be equalization. Indeed, this is what would have happened under the 1995 federal proposals around 2007-2010, when EPF cash transfers went to zero. The 1996 Budget indicates its intention to move towards an equal cash amount per capita, but at a pace that will still maintain a significant regional redistribution element.

5. *National standards for access* - In return for the creation of a stable, predictable, and fair cash transfer system, the provinces should agree to establish a set of national access standards, that they will adhere to as a *minimum*. These standards might also include some specific elements that would be of interest to all provinces and could assist Canadian citizens, regardless of where they live. Examples include:

- Full access to the health system for a Canadian living in any province;
- Full access to the health system for a Canadian visiting any province;
- Equal treatment of health costs incurred abroad, regardless of province of residence;
- Opportunity to apply for entry to any educational institution in Canada, with admittance ensuring equal tuition cost regardless of province of residence; and
- Ability for any Canadian to receive social assistance in any province, if otherwise qualified in that province. Such assistance is to be available without residency requirements.

6. *National standards for performance* - Although more controversial, it may be useful if there are at least some minimum standards for performance, such as:

- National testing of secondary and post-secondary students (universities, colleges and vocational training);

- Testing of government-provided training;
- Maximum waiting times for health care services;
- Maximum mortality rates for various events (infant mortality, appendicitis, etc.);
- Maximum levels of prevalence for communicable diseases; and
- Minimum nutrition levels for children living in poverty.

Such measures could be part of a broader set of goals and objectives for social indicators, as is done in Oregon [Oregon 1995]. One key aspect would be to ensure that progress is being made over time and across regions.

7. *Cyclical instability* - Since cyclical shocks and contracyclical actions are a federal responsibility, it is not appropriate for the transfers to the provinces or to persons to be reduced in a downturn. Indeed, it is more sensible to be increasing them as part of a stabilization effort, if the federal government chooses to do so. Social assistance, which is particularly cyclically sensitive, might be better treated with some additional funding mechanism that promotes planning for cyclical stability (e.g., some fund for handling cyclical increases).

8. *Indexing to population* - Since provincial population growth rates may be faster or slower than national rates, it is desirable that formulas used in the allocation of any transfers reflect this reality in some form.

9. *Indexing to real growth* - Since more real growth usually enhances the capacity of a province to deal with economic demands more easily, indexing to real growth should **not** be part of the formula. If GDP falls nationally, or for a region, this should not affect the transfers, except for contra-cyclical considerations.

10. *Indexing to inflation* - Inflation is not something over which the provinces have much control. Given the federal responsibility for its management, it is appropriate for the transfer to be indexed in some way for inflation. If a general measure is not desired, then there could be agreement on a way for defining an indexing factor.

Compliance Issues

If one or more provinces will not comply with the national standards, then the issues of penalties and processes to bring about compliance are real challenges. As well, conflicts may arise between two provinces, particularly if there are movements of people from one province to another for purposes of receiving health care, education, or social assistance. Of course, provinces may also have major differences with the federal government, particularly if "iron-clad" agreements change in future federal budgets.

The design of compliance "incentives" depends on the nature of the "agreement" between the federal government and the provinces. If the program remains a federal one, with no real role for the provinces except to graciously accept the money and comply, then the current system of the threat of withholding cash is likely to be the default enforcement mechanism. If another form of agreement were to evolve, then issues of compliance would be dealt with as part of the design of that new arrangement. This issue is discussed further below.

The Current Federal CHST Program

How does the CHST match the criteria above? Essentially, the current program is a federal one, with limited indexing to both real growth and inflation (GDP less 1% after a transitional period). There is no cyclical component. Provinces will have to handle any increased demand for rising social assistance from their own resources or by spreading their weaker revenue among more recipients in a recession.

The major problem is that any federal government can unilaterally change the program without notice and for whatever purpose it may wish to achieve. Such an action is not unthinkable, since federal governments have been cutting both EPF and CAP now for many years.

A National Program?

Although the CHST is now a federal program, it is "thinkable" that a "national" program might be more appropriate for social areas. In my mind, a "national" program is one in which the federal *and* provincial governments *cooperate*, with at least an equal voice between the federal government and some majority of the provinces. Changes in transfers would then be jointly discussed and be a result of joint deliberations. The rationale for such programs is that there are large social externalities associated with good social policy, with delegation of total responsibility to more geographically-specific levels likely to result in substantial under-investment in social capital.

More Radical Approaches

Federal Programs

One or all of the social programs could be designated as a federal program, either by constitutional amendment or by delegation from the provinces to the federal government. With UI a federal program, there might be some logic to putting social assistance at the same level. Universities could be viewed as an area that has expanded in a way not anticipated by the founding fathers who designated education as a provincial responsibility. With increased emphasis on healthiness over the lifecycle it could be argued that the federal government should undertake such a long-term program as health care for all of its citizens.

Perhaps the strongest argument for the joint consideration of all of the social programs are the many linkages between them and their interdependence with labour market outcomes and income distribution.

Provincial Programs

At the other extreme, provinces could deliver *all* of the social programs, including those currently linked to the labour market such as Unemployment Insurance (renamed as Employment Insurance), training, native programs, or old age (veterans pensions, OAS/GIS).

What guide is there to the "appropriate" level? Before answering this question it is important to consider whether there is *one* organization called *government*, with multiple levels (federal, provincial, and local) or a number of competing organizations (governments). If one subscribes to

the single government view, then there is much scope for distinguishing between the responsibilities for delivery, funding, research, and setting of standards of access and performance. If, however, there are competing jurisdictions of governments, then there is not much point in discussing who should do what, since each will try to take credit for providing the service, while off-loading the costs and risks onto others.

On the assumption of a federal state, then delivery of services as close to the need (subsidiarity) with national planning of the system, research, standards setting, and funding is likely to be most appropriate and efficient. (By "national" is meant federal plus provincial plus local delivery entities.)

What if coordination can't be achieved? One can wring one's hands, but it helps to recognize that it is not the end of the world. Indeed, inefficiencies may be acceptable if the local community is able to express its voice and more readily accept the taxes, queues, and other aspects of such programs.

Some would simply counsel giving up on state delivery of health, social services, or education with a strong belief that the market will deliver the appropriate level of services most efficiently. To move to such a system will require some transition, perhaps with privatization of existing facilities and a substitution of private insurance for public funding. Although it would be useful to report that such a move would lead to substantially fewer resources being needed, the US example for health care is not reassuring. Nor are other privatization experiments where comparisons have been made.

Of course, the "ideal" experiment has not been run. If all citizens had adequate incomes, then issues of using private sector producers and markets for allocation would be less controversial. That is, if governments adopted a GAI (guaranteed annual income), financed with the funds now going to health, education, UI, tax expenditures and social services, then it may be possible to have similar outcomes as at present, without the need for government to deliver the services directly. This approach would require a sufficiently high level of GAI so that everyone could achieve an adequate standard of consumption. Until many other social experiments are run, the GAI will remain only a gleam in some economists' eyes.

The Next Ten Years

As Canada emerges from its fiscal nightmare, the debate will begin on how to most effectively use the improved fiscal room that emerges from lower real interest rates, large cutbacks in services, and some return of economic performance towards more normal levels. Of course the "plans" may be dashed by the economy being thrown back into another recession, either because of an external shock (e.g., US interest rate hike, OPEC price shock) or domestic policies (e.g., Bank of Canada moves, Quebec separation completed).

With the recent report of the National Forum on Health [NFH 1997], discussion has begun on new areas for federal and provincial governments to improve the national health system. In the Liberal Party "Red Book II" [Liberal 1997, p. 71 ff.], health care received substantial emphasis. Possible areas for further undertakings include:

- Pilot programs for alternative primary care delivery;
- Home care extensions and further tax credits for caregivers;
- Public coverage of prescription drugs for all, eliminating private insurance and moving to a single-payer system;
- Health promotion, particularly of lifestyle choices of diet, exercise, hygiene, smoking, alcohol use, drug use, and sexual activity; and
- Health information systems for Canadians and health practitioners.

In each of these areas an opportunity exists for the development of a truly *national* approach, with full participation of both the federal and provincial governments, along with the health community. Only time will tell if such an approach becomes a reality.

Individual Canadians have an important role to play. First they need to insist that federal and provincial governments stop playing games and start cooperating on a regular basis. Then, citizens need to insist on the regular publication of real objectives for health, education, and social assistance, along with measured progress against these objectives. And if these objectives are not met, they must vote for a change in government.

Summary

Contra-cyclical fiscal policy is dead. The term "stabilization policy" has been changed to mean price and balance of payments stability, through higher unemployment and a weak domestic economy. Trust in governments, corporations, and each other is deteriorating. Federal and provincial governments "shoot" at each other, through citizens, by downloading, uploading, and otherwise shirking their responsibilities. Corporations focus less on people - employees, customers - and more on maximizing short-term gains in the stock market through downsizing.

Is there any hope? Yes, there is. The first step is the recognition that we have problems. The development of social capital - through the actions of corporations, governments, and individuals - is the next step. Simultaneously, it is crucial that we restore the economy to full employment, with a strong consensus between business, labour, and governments to keep it there. Federal-provincial relations must become more cooperative - there is (or should be), in the end, only one government. This means that in a number of areas, national (in the sense of joint or cooperative federal and provincial) institutions will be needed. Finally, all of this will work if, and perhaps only if, the people demand this from their government, their employers, their unions, and themselves.

Recall the challenge of Senator Forsey in his last essay:

"I am not interested in a Canada that would be just a splash on the map, with a six-letter word scrawled across it.

The only Canada I want to preserve is a Canada that can do something:

for its own people;

for the hungry two-thirds of the world;

for the survival of the planet;

not a phantom that can only watch helplessly as we tumble down a steep place to destruction."

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